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Supreme Court of the United States.

OCTOBER TERM, 1935.

No. 41.

GENERAL UTILITIES AND OPERATING COMPANY,

Petitioner,

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF OF *AMICUS CURIAE.*

RUSSELL D. MORRILL,
Amicus Curiae.

WALTER S. ORR,
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GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
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BRIEF OF *AMICUS CURIAE*.

This case comes up on writ of certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

Questions Presented.

Upon the record the following questions are presented to which this brief is addressed:

1. Does a corporation realize a taxable gain upon the distribution to its stockholders as a dividend in kind of property which has appreciated in value in its hands?

2. If not, was the sale of stock under the circumstances here made by or for the account of the corporation rather than the stockholders?

Outline of Argument.

I. A corporation realizes no taxable gain or income from a distribution of a dividend in kind out of surplus due to appreciation in value of its assets.

(a) No money or other property having a fair market value is received.

(b) No assets are freed of liabilities to the general use of the corporation and the corporation has nothing which it did not possess before disposition.

II. The sale of stock in this case was made by the stockholders for their own account and the corporation realized no taxable gain on such sale.

I.

A corporation realizes no taxable gain or income from a distribution of a dividend in kind out of surplus due to appreciation in value of its assets.

Gross income, within the meaning of the Revenue Act of 1928 (Section 22, *infra*, p. 12) and the Sixteenth Amendment to the Constitution, includes "gains * * * derived * * * from sales, or dealings in property * * * growing out of the * * * use of * * * such property * * * and including income derived from any source whatever." Under the Revenue Act of 1928 (Section 111(a), *infra*, p. 13), with exceptions not here involved, "* * * gain from the sale or other disposition of property shall be the excess of *the amount realized* therefrom over the basis provided in Section 113 * * *." *"The amount realized* from the sale or other disposition of property shall be *the sum of money received plus the fair market value of the property* (other than money) *received.*" (Section 111(c), *infra*, p. 13). (Emphasis supplied.) The basis under Section 113 (*infra*, p. 13), so far as here concerned, is the cost of property.

When, as here, a corporation distributes to its stockholders by way of a dividend in kind, property which has appreciated in value, it receives no sum of money or property having a fair market value, and, therefore, there is no amount realized. The corporation has disposed of property having a cost, but there is nothing *realized* thereon within the definition in the law. The essential element of income is lacking in such a transaction. There is nothing "of exchangeable value proceeding from the property" and "coming in, being 'derived', that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal."

Eisner v. *Macomber*, 252 U. S. 189, 207;
First National Bank of Ogden v. *Burnet*, 53 Fed. (2d) 919 (C. A. D. C.).

The statute specifically requires the amount realized to be in money or property having a fair market value. Admitting that there has accrued to the capital of the corporation an increment or growth in its investment and a surplus, in the sense of an excess of value of assets over liabilities, and admitting that it has been able to make this unsevered increment available to its stockholders and has thereby gained an economic benefit, it still falls short of receiving taxable gain or income as defined by the statute and the cases. "The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer." *Weiss* v. *Wiener*, 279 U. S. 333, at page 335.

As stated by this court in *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509:

> "In determining the definition of the word 'income' thus arrived at" (referring to the definition laid down in *Eisner* v. *Macomber*, *supra*), "this court has consistently refused to enter into the refinements of lexicographers or economists and has approved, in the definitions quoted, what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution."

See also *Eaton* v. *White*, 70 Fed. (2d) 449, 452 (C. C. A. 1), where the court stated:

> "The statute emphasizes that taxable gain is 'the amount realized' in money received and fair market value of the property received. We know of no case that recognizes the enhancement of the market value of property already possessed as equivalent to the receipt of property with a market value. • • •
>
> These situations only emphasize the advisability and necessity of adhering to the well established rules and

principles in dealing with legally established corporate entities and the status and character of corporate shares. To abandon these moorings, would create difficulties and uncertainties more objectionable in their results than any seeming inequities which would be eliminated or prevented."

The distribution of appreciated property as a dividend in kind may be a disposition, but it is contended that it is not such within the meaning of the applicable statute. The rule of *ejusdem generis* should be applied and disposition construed to mean a disposition analogous to a sale. *First National Bank of Ogden v. Burnet, supra.*

Congress has recognized that a distribution in kind did not result in taxable gain or loss to a corporation, and clearly indicated its intention that the language of the Revenue Acts should not be interpreted as giving rise to gain or loss on such a distribution. Preliminary Report of a Subcommittee of the Committee on Ways and Means, "Prevention of Tax Avoidance," House Committee Print, 73rd Cong. 2nd Sess., Item (32) (c), page 23.

A gift is a disposition of property but a regulation under the New York Income Tax Law to the effect that gain or loss resulted to the donor from a gift was held invalid in *People ex rel. Brewster* v. *Wendell,* 196 App. Div. (N. Y.) 613. See also, *People ex rel. Wilson* v. *Wendell,* 196 App. Div. (N. Y.) 596. In *Taft* v. *Bowers,* 278 U. S. 470, this Court recognized that a donor realized no taxable income by making a gift of property which had increased in value. The Treasury Department has ruled that the death of an individual does not work such a disposition of property as results in gain or loss. A. R. R. 249, 3 C. B. 145; O. D. 219, 1 C. B. 180; and O. D. 731, 3 C. B. 210, and yet, a father may receive substantial economic benefit from a gift or bequest to his children.

It has been the consistent interpretation of the Treasury Department that no gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however, they may have appreciated or

depreciated in value since their acquisition. Article 71 of Regulations 74 under the Revenue Act of 1928 and Article 548 of Regulations 69 and 65 under the Revenue Acts of 1926 and 1924. A corporation discharges its obligations to its stockholders as much by a distribution in liquidation of appreciated property as it does in the distribution thereof by an ordinary dividend. With respect to the realization of taxable income or gain, there is no real basis of distinction between a gift, bequest, distribution in liquidation and an ordinary dividend in kind.

Conditions under which deduction of losses is allowed by the law are distinguishable from those under which income or gain is realized.

> "The power to tax income like that of the new corporation is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed."
>
> *New Colonial Ice Co., Inc.* v. *Helvering,* 292 U. S. 435, at pages 440, 442.

It is submitted, that a loss cannot be sustained under Section 111 (*infra,* p. 13), unless some amount is realized in money or property having a fair market value. However, deduction is allowed under Section 23 (c) and (f) (*infra,* p. 12) of losses sustained by means other than "sale or other disposition". The losses allowed in *United States* v. *S. S. White Dental Manufacturing Co.,* 274 U. S. 398, and *DeLoss* v. *Commissioner,* 28 Fed. (2d) 803 (C. C. A. 2nd), were sustained under conditions in no way analogous to the facts of the present case and under specific statutory provisions unrelated to Section 111 of the 1928 Act.

Income, too, may be realized other than by the sale or disposition of property. *Old Colony Trust Co.* v. *Commissioner,* 279 U. S. 716; *United States* v. *Boston & Maine R. Co.,* 279 U. S. 732; *Maryland Casualty Company* v. *United States,* 251 U. S. 342; *Charleston & W. C. Ry. Co.* v. *Burnet,* 50 Fed. (2d) 342; *United States* v. *Kirby Lumber Co.,* 284 U. S. 1.

Those cases have no application in the instant case. The corporation here received nothing on account of services performed, rent, or reduction or recovery on account of deductions from gross income in prior years. The dividend obligation is not a liability deductible from gross income. No liability was satisfied at less than face amount so as to release to the general uses of the corporation any assets previously offset by obligations.

In *Commissioner of Internal Revenue* v. *Rail Joint Co.*, 61 Fed. (2d) 751 (C. C. A. 2nd), the taxpayer, a New York corporation, in 1914 approved an appraisal of its assets which added $3,000,000 to its surplus account. It then declared a dividend payable in bonds and issued and distributed among its stockholders its own debenture bonds of a face amount of $2,000,000. In 1926 and 1927 some of these unmatured bonds were purchased by the corporation at less than face value. Such bonds were cancelled and the difference between the purchase price and the face value was credited to surplus. The question was whether the corporation realized a taxable gain when the bonds were purchased and cancelled.

The Court stated in its opinion, page 752:

> "In paying dividends to shareholders, the corporation does not buy property from them. Here *the respondent"* (corporation) *"never received any increment to its assets, either at the time the bonds were delivered or at the time they were retired.* * * * Hence it is apparent that the corporation received no asset which it did not possess prior to the opening and closing of the bond transaction, and it is impossible to see wherein it has realized any taxable income." (Italics ours.)

The corporation here received no asset in the transaction in question which it did not possess before.

The situation might well be different if the directors had declared a cash dividend and thereby incurred a fixed debt which could be recovered in cash by the stockholders and which could not be revoked by subsequent action of the directors. *Flynn* v. *Haas Bros.*, 20 Fed. (2d) 510 (C. C. A.

9th); *Staats* v. *Biograph Co.*, 236 Fed. 454 (C. C. A. 2nd); *Callanan Road Improvement Co.*, 12 B. T. A. 1109; *Bacon-MacMillen Veneer Co.*, 20 B. T. A. 556; *Fruit Belt Telephone Co.*, 22 B. T. A. 440.

However, the declaration of a dividend and the fixing of the amount, time and terms of payment thereof whether in stock, cash or property, are entirely within the discretion of the board of directors of a corporation and a court cannot substitute its judgment for that of the directors, if honestly exercised. *Liebman* v. *Auto Strop Co.*, 241 N. Y. 427, 433; *Richter & Co.* v. *Light*, 116 Atl. 600 (Sup. Ct. of Errors of Conn., March, 1922). If the declaration is conditional, the conditions will be enforced. *Tepfer* v. *Rival Gas & Electric Fixture Supply Co.*, 117 N. Y. S. 959 (Sup. Ct. Ap. Term, June, 1909, aff'd without opinion, 121 N. Y. S. 1149); *Bryant* v. *Mutual Life Insurance Co.*, 109 Fed. 748 (Cir. Ct., N. D., Tenn., May, 1901); *Hyams* v. *Old Dominion Copper Mining and Smelting Co.*, 89 Atl. 37 (Court of Chancery of New Jersey, November 1913); *Colorado* v. *Great Western Sugar Co.*, 29 Fed. (2d) 810.

Section 115(a), Revenue Act of 1928 (*infra*, p. 13), defines "dividend" as "any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913". Subdivision (b) of that section (*infra*, p. 13), provides that

> "For the purposes of this act, every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *"

A corporation having earnings or profits accumulated after February 28, 1913, represented by cash or assets, which declares a dividend payable in cash, thereby creates a debt and divides and sets over to its stockholders a portion of its cash or property representing such accumulated earnings. A liability payable in cash is thereby imposed upon certain of the corporation's assets representing the previously realized and accumulated earnings or profits. *Flynn* v. *Haas Brothers*,

and *Staats* v. *Biograph Co., supra.* If the corporation then appreciates on its books an asset, thereby creating additional surplus and subsequently appropriates the appreciated asset to the satisfaction of the liability for the cash dividend which was in effect a lien upon the assets prior to the appreciation, it thereby releases assets previously covered by the obligation of the dividend to the general uses of the corporation. The assets so released are free in the hands of the corporation to be used in satisfaction of claims of creditors or for other purposes.

When, however, a dividend is not declared payable in cash but in certain identified property, even though the value of such property be stated, it is submitted that the obligation of the corporation is to distribute the particular property and not a sum of money. The obligation or liability is imposed upon only that particular item of property on which the corporation has never realized the gain and not on any other property representing earnings or profits previously accumulated. It is submitted that the delivery of the particular property regardless of fluctuations in its value between declaration and delivery satisfies the corporation's obligation and does not in any way add to the assets available for the general uses of the corporation. There is a vital distinction in the form of the dividend and the Court cannot substitute its discretion for that of the directors.

II.

The sale of stock in this case was made by the stockholders for their own account and the corporation realised no taxable gain on such sale.

This Court has been at great pains to point out time and again that a corporation is a legal entity and as such wholly different and distinct from its stockholders, and that a leading purpose of the incorporation laws and of those who act under them is to interpose a nonconductor, through which,

in matters of contract, it is impossible to see the men behind. *Eisner* v. *Macomber, supra; Klein* v. *Board of Supervisors,* 282 U. S. 19, 24; *Donnell* v. *Herring-Hall-Marvin Safe Co.,* 208 U. S. 267, 273; *Dalton, et al.* v. *Bowers,* 287 U. S. 404; *Cannon Mfg. Co.* v. *Cudahy Co.,* 267 U. S. 333.

In this case one of these entities, the petitioner, by proper corporate action, transferred and delivered title to property consisting of shares of stock to the stockholders without legally binding condition or restriction.

A corporation acts through its Board of Directors and officers; its property is not subject to the control or disposition of its members or stockholders; they have no power to sell or encumber the corporate properties, and, it is submitted, the corporation has no power to sell or encumber the property of its stockholders. *Sellers* v. *Greer,* 50 N. E. Rep. 246; *2 Cook, Stock, Stockh. & Corp. Law* (3rd Ed.) § 709; *Allemong* v. *Simmons,* 124 Ind. 199, 23 N. E. 768; *Humphreys* v. *McKissock,* 140 U. S. 304, 11 Sup. Ct. 779; *Hopkins* v. *Lead Co.,* 72 Ill. 373; *England* v. *Dearborn,* 141 Mass. 590, 6 N. E. 837; *Manufacturing Co.* v. *White,* 42 Ga. 148; *Russell* v. *McLellan,* 14 Pick. 63.

As stated by the Circuit Court of Appeals for the Second Circuit in *George H. Chisholm, Petitioner,* v. *Commissioner of Internal Revenue,* 79 Fed. (2) 14, certiorari denied November 11, 1935;

> "The decisions on which the commissioner relies are quite different; they concern sales in which the buyer did not gain dominion over the goods, but acted as a trustee or agent for the seller, the taxpayer. Such transactions contradict a sale, which presupposes that the seller loses not only title but control. *Esperon* v. *Com'r.,* 49 Fed. (2) 359 (C. C. A. 5); *MacQueen* v. *Com'r.,* 67 Fed. (2) 857 (C. C. A. 3); *Hellebush* v. *Com'r.,* 65 Fed. (2) 902 (C. C. A. 6); *Burnet* v. *Lexington I. & C. Co.,* 62 Fed. (2) 906 (C. C. A. 4); *Taylor G. & O. Co.* v. *Com'r.,* 47 Fed. (2) 108 (C. C. A. 5); *Atkins* v. *Com'r.,* 76 Fed. (2) 387 (C. C. A. 5); and *Shoenberg* v. *Com'r.,* 76 Fed. (2) (C. C. A. 8)."

There is nothing in the record here to indicate an agency on the part of the stockholders.

In *S. B. McMaster, Inc.* v. *Chevrolet Motor Co.*, 3 Fed. (2d) 469, 474 (District Court, E. D. South Carolina, January 6, 1925), after reviewing various definitions of agency, stated as follows:

> "Without undertaking to review in detail all the various definitions that have been made of the term, I think it may safely be asserted that they all recognize two distinctly essential elements. The first is that *the agent is a representative and acts, not for himself, but for another.* The second is that *his acts* within the scope of his authority *must be binding upon his principal.*"

It is submitted that in this case the essential elements of agency are lacking in that it has not been shown or indicated in any way that after the distribution of the stock to the stockholders they acted, in making the sale, not for themselves but for the corporation; and secondly, it has not been shown that the acts of the stockholders were in any way binding upon the corporation.

In the absence of facts to indicate that the stockholders did not gain dominion over the property transferred or acted as trustee or agent of the corporation, sales and transfers between corporations and their stockholders have been upheld as *bona fide.*

See:

Fruit Belt Telephone Co., supra;
G. C. M. 714, V-2 C. B., page 72, 1926;
Taplin v. *Commissioner of Internal Revenue,* 41 Fed. (2d) 454;
Motter v. *Patterson,* 68 Fed. (2d) 252;
Helvering v. *Ackerman,* 71 Fed. (2d) 586;
U. S. v. *D., L. & W. R. R. Co.,* 238 U. S. 516.

Even though the motive for the transfer in this case was the avoidance of taxation, it does not establish liability for tax so long as the transaction is *bona fide* and that the pur-

pose of the parties was to do what they purported to do. There can be no question in this case but that the purpose was to distribute a dividend in kind to the stockholders prior to the sale of the property in question, a perfectly legal and permissible act on the part of the corporation, and this purpose was in every respect carried out.

The corporation parted absolutely with the title to the stock and the stockholders acquired title free of restriction. *George H. Chisholm, petitioner,* v. *Commissioner of Internal Revenue, supra; Gregory* v. *Helvering,* 293 U. S. 465.

It is manifestly inconsistent to hold, as did the Court below, that the petitioner declared and distributed a dividend of stock in kind which gave the stockholders a vested right in the property the subject of the dividend, and at the same time hold that the sale of such stock by the stockholders should be attributed to the corporation through an agency or otherwise.

III.

Conclusion.

Both questions should be answered in the negative and the judgment of the Circuit Court of Appeals should be reversed and decision of the United States Board of Tax Appeals affirmed.

Dated, November 12, 1935.

RUSSELL D. MORRILL,
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APPENDIX.

Revenue Act of 1928, c. 852, 45 Stat. 791, 797, 799, 800, 815, 816, 818, 822.

Sec. 22. *Gross Income.*

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

Sec. 23. *Deductions from Gross Income.*

In computing net income there shall be allowed as deductions:

• • •

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft.

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

Sec. 111. *Determination of Amount of Gain or Loss.*

(a) *Computation of Gain or Loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

* * *

(c) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Sec. 113. *Basis for Determining Gain or Loss.*

(a) *Property Acquired After February 28, 1913.*—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; * * *.

Sec. 115. *Distributions by Corporations.*

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 208 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 113.